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No. 85-599

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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TABLE OF AUTHORITIES

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The fact that respondents' brief and ours have something of a ships-passing-in-the-night quality reflects respondents' litigation strategy, which, in this Court as in the courts below, has basically been one of confession and avoidance. Respondents have accepted virtually every contention of a legal nature that we have made. They agree (Br. 24) that this case is governed by Section 513(c) of the Code,[1] which defines a "trade or business" as "any activity which is carried on for the production of income from the sale of goods or the performance of services." They acknowledge (Br. 30-31) that Congress, in legislative history contemporaneous with the enactment of Section 513(c), specifically discussed the group insurance activities of several categories of tax-exempt organizations—fraternal beneficiary societies and voluntary employees' bene-

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the periods at issue (the Code or I.R.C.).

ficiary associations—and referred to those activities as a "business." S. Rep. 91-552, 91st Cong., 1st Sess. 68 (1969); H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1 at 47 (1969). See U.S. Br. 19-22. Although respondents say that this legislative history "is not relevant here" (Br. 30), they make no effort to explain it away or to show that the Endowment's group insurance activities differ in any functional respect from the activities to which Congress referred. Respondents acknowledge that three courts of appeals[2] have held that the group insurance activities of another category of tax-exempt organization—business leagues—are a "trade or business," and they seem to agree (*id.* at 32-35) that those cases are correct in both reasoning and result. See U.S. Br. 25-28. Respondents acknowledge (Br. 35) that those cases cannot be distinguished from this one on the ground principally adduced by the courts below—that the associations marketing insurance there were exempt under Section 501(c)(6), whereas the Endowment is exempt under Section 501(c)(3)—and they appear to acknowledge that the Endowment performs essentially the same insurance services, and markets essentially the same insurance products, that those business leagues did. Finally, respondents seem to agree (Br. 34-35) that the Endowment's insurance operation entails "extensive activity over a substantial period of time with intent to earn a profit"—a fact which would mean, under the reasoning of the Fourth, Fifth, and Sixth Circuits, that the Endowment's insurance operation is a "trade or business." See *Louisiana Credit Union League*, 693 F.2d at 532; *Professional Insurance Agents*, 726 F.2d at 1102.

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[2] See *Carolinas Farm & Power Equipment Dealers* v. *United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League* v. *United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents* v. *Commissioner*, 726 F.2d 1097 (6th Cir. 1984).

Having agreed with us on the law, respondents place their case squarely on what they call the Claims Court's "findings of fact" (Br. 18). According to respondents, the Claims Court found as a fact that the Endowment " 'is not a business and is not making a profit from its enterprise' " (*id.* at 16, 24-25 (quoting J.A. 498)). This finding was assertedly based on subsidiary factual findings that the Endowment's insurance revenues are not derived "from" its sale of insurance products or "from" its performance of insurance services (I.R.C. § 513(c)), but rather are derived "from" charitable fundraising, reflecting "the generosity of the [Endowment's] members and their intent to support [its] charitable activities" (Br. 17). The Endowment asserts that these "findings of fact," having been deemed "not clearly erroneous" by the Federal Circuit, "are conclusive on the question of whether [it] had unrelated business income" (*id.* at 18), so that there is really nothing for this Court to do but affirm under the two-court rule.

This is essentially the same argument that respondents made in unsuccessfully opposing certiorari. See Br. in Opp. 3-7, 10-16. As we have shown (Reply Br. 7-9, U.S. Br. 32-39), the "findings of fact" on which respondents place such reliance either are not findings of fact at all, or, if they are findings of fact, are irrelevant as a matter of law in deciding the questions presented. We have little to add to what we have already said on that score.

At the end of the day, it seems to us that the outcome of these cases really depends on the answers to two questions. The first is: "Does it make any difference that the Endowment exacts a waiver of policy dividends from its insureds as part of the purchase price of its insurance, instead of soliciting a voluntary charitable contribution from those individuals in the same amount?" The second question is: "Did respondents meet their burden of proving that the price the Endowment charged for its insurance exceeded the fair market retail value of the insurance that its mem-

bers acquired?" We think that the answer to the first question is "Yes" and that the answer to the second question is "No." In the pages that follow, we explain our answers to these two questions, then reply to a few other points.

1. In our opening brief (at 24-25), we suggested that if the Endowment had consented to refund policy dividends to its members, coupling the rebate with a request that the members voluntarily donate the dividends back to it, it would have a strong claim that any funds thus contributed came "from" charitable solicitations rather than "from" its marketing of insurance. The Endowment treats this suggestion as tantamount to a concession that its insurance revenues are nontaxable (Br. 21-23). Policy dividends, the Endowment points out, "are nothing more than a reduction in the amount of premiums paid," so that "as a rule they are not taxed" to the premium-payor (*id.* at 21). The Endowment accordingly professes astonishment that "the Government here would tax the policy dividends as gross income" in its hands, for it sees "no distinction in principle" between its actual modus operandi and the one that we hypothesized. In respondent's view, the difference between a program in which members have a choice about getting their dividends back, and one in which they do not, is purely a matter of "form" (*id.* at 23).

We could not disagree more strongly. The difference in our view is both substantial and dispositive. And the difference is equally pronounced at the organizational and at the membership levels.

Policy dividends, as respondent notes (Br. 21), reflect the excess of the gross premiums that an insured pays over the portion that the underwriter retains to cover its claims settlement costs, administrative expenses, and profit. When such dividends are distributed to the insured who paid the premium, they function as a retroactive reduction of his cost, and, unless he has previously claimed a tax deduction for his cost, the dividends do not ordinarily

represent taxable income to him. Nor do such dividends represent taxable income to a group policyholder that receives them from the insurance company, holds them temporarily if at all, and then passes them through to the individual insureds who paid the premiums for the group coverage. In that situation, the association holding the group policy acts as "a mere conduit between the member participants and the insurance company." *New York State Ass'n of Real Estate Boards Group Insurance Fund* v. *Commissioner*, 54 T.C. 1325, 1335 (1970). Because the group policyholder functions in that situation essentially in an agency capacity, it is not taxed on the dividends passed through to the insureds. Rev. Rul. 64-258, 1964-2 C.B. 134; G.C.M. 38955 (June 29, 1982), *reprinted in* [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1157. See Resp. Br. 21.

The situation is altogether different when the group policyholder refuses to refund the dividends to the premium-payors, but instead insists that they waive the dividends as an absolute condition of buying the insurance. In that event, obviously, the association cannot exclude the dividends from its income on the theory that it is acting as a "conduit" between the underwriter and its members. Equally obviously, the association cannot exclude the dividends from its income on the theory that they represent a retroactive reduction of its premium cost, since it did not pay the premiums to begin with. Under these circumstances, the conclusion is inescapable that the insurance revenues retained by the association, contrary to respondent's contention, represent income in its hands.

In *Louisiana Credit Union League*, a decision whose reasoning and result respondents profess to accept (Br. 32-35), the Fifth Circuit considered and rejected the very argument that the Endowment makes here. The business league that served as group policyholder in that case noted that its revenues took the form of "premium rebates" from

the underwriters, and it "invoke[d] the established principle that mutual insurance premium rebates are not income to the policyholder" (693 F.2d at 531). The court found that principle "inapposite to the case at bar" (*ibid.*). The association, the Fifth Circuit observed, did not "act as a conduit between insured and insurer," since, after receiving payments from the underwriter, it "ma[de] no corresponding distribution to the individual * * * policyholders" (*ibid.*). The court accordingly held that "the insurance-related payments received by the [association] must be considered income in its hands," income that represented the fruit of its considerable promotional, marketing, and administrative efforts (*ibid.*).

The Fifth Circuit's reasoning, which is equally applicable here, surely comports with common sense. If the Endowment had refunded the dividends to its members, and the members had voluntarily donated the money back to it, it would have a good argument that the money came to it in the form of charitable contributions, that is, from a source *wholly independent* of its insurance operation. As it is, all the money that the Endowment receives comes to it in the form of insurance-related payments—either as premiums from its members or as policy dividends from its underwriters—so that its revenues necessarily constitute income "from" the insurance-related products that it sells and "from" the insurance-related services that it performs (I.R.C. § 513(c)).[3]

[3] The Endowment argues that it does not "sell insurance" (Br. 7) and that Illinois law forbids it to earn commissions as an insurance "agent or broker" (*id.* at 27 n.11). This is a quibble. What respondent "sells" is participation in group insurance plans that it contracts with insurance wholesalers to underwrite. As the Claims Court found (Pet. App. 26a), respondent's program is "based upon the sale of group life insurance." The business leagues in the Fourth, Fifth, and Sixth Circuit cases, whose reasoning respondent purports to accept (Br. 32-35), "sold" precisely the same commodity. Respondent is as much engaged in "sales" as any real estate agent, jobber, or other middleman who brings buyers and sellers together.

The distinction between the Endowment's program and one in which members are entitled to get their dividends back is equally apparent from the insureds' point of view. The Endowment's members who balked at waiving their dividends, but who found that they "either agreed to that or didn't get the insurance" (J.A. 448, C.A. App. 1276, 1277), unquestionably saw the distinction. The insured who struck the dividend waiver clause from his application form, only to be told that he could not get insurance without accepting the same terms as everybody else (J.A. 293-295, C.A. App. 1135), unquestionably saw the distinction. Even the individual respondents, who testified to their awareness of the charitable uses to which their funds would be put, stopped short of testifying that, given the option, they would have elected to assign their dividends to the Endowment. See U.S. Br. 6-7. To put it bluntly, the alternative modus operandi that we hypothesized would provide an acid test of charitable intent. The Endowment's brief speaks often of its members' "spirit of generosity" (Br. 20) and of their unswerving "intent to support [its] charitable activities" (*id.* at 17). But the inescapable fact is that the Endowment requires them to waive their dividends.

2. This brings us to what we think is the second key question in the case, which concerns the "value" of the insurance that the Endowment offers for sale. At this point, the Endowment's argument and that of the individual respondents merge. The Endowment argues that its insurance activities really resemble "[c]harity dinners [or] concerts" (Resp. Br. 37-38, 42-43). As we have noted (U.S. Br. 42-43), a payment to a charity in certain circumstances may be treated as a "dual payment," that is, as in part a purchase of goods and services and in part a charitable contribution. A common example of a "dual payment" is where a taxpayer buys a ticket to a concert or dinner held to benefit a charity, the ticket price being set at a level far

in excess of the usual price of admission, or of the retail value of the meal. As respondents note (Br. 37-38), the fact that attendees at these functions have no choice about paying an "excessive" price—they must pay the full freight or not go—does not normally defeat a charitable-contribution deduction in the amount of the "excess." The fact that ABA members have no choice about waiving their dividends, respondents argue, should similarly make no difference in determining whether (1) the Endowment is in a "trade or business" or (2) the members are entitled to a tax deduction.

The factual premise of this "dual payment" argument is that the price the Endowment charges for participation in its group insurance plans vastly exceeds the fair market retail value of the coverage that its members acquire. To investigate that premise—a premise as to which respondents, as they concede (Br. 39-40), had the burden of proof—a trial was necessary. The evidence at trial showed that the Endowment advertised its premium charges as "reasonable," "attractive," "affordable," "economic," or "modest" (J.A. 239-240, 241; C.A. App. 988-1012, 1226-1268). It did so because it knew that its members were looking for "a good deal, and a good buy" (Br. in Opp. B12). The Endowment constantly monitored and adjusted its gross premium levels to keep them within the competitive range (Pet. App. 3a-4a, 28a-29a; J.A. 127-128; C.A. App. 1279, 1282). The evidence showed that the Endowment's prices, comparatively speaking, more than held their own in the retail market generally. In 1978, the Endowment conducted a study that compared its premium rates with the prices charged for group life insurance offered by state and local bar associations and similar groups (C.A. App. 1378-1384). The study showed that, of the 29 state bar plans considered, twenty cost *more* than the Endowment's, only four cost less, while five

were adjudged not suitable for comparison (*ibid.*).[4] The Endowment thereafter detected some slippage in its standing, and in 1980, on the recommendation of the underwriter, it lowered the rates for its life insurance so as to "make the life plans competitive in today's market" (J.A. 169, 191-192; C.A. App. 1074-1080, 1119). The Endowment concurrently reviewed its rates for hospital and disability coverage, concluding that "[t]he present premium * * * is competitive in the marketplace" (C.A. App. 1120, 1121).

The individual respondents testified that they regarded the Endowment's gross premiums as "reasonably or competitive[ly] priced," although not necessarily the cheapest on the market (J.A. 263-264, 269-270, 287). One of the individual respondents and one nonparty insured testified that they had previously held group insurance through their state bar associations, but had discontinued that coverage because it cost more than the Endowment's (J.A. 265-267, 389-392, 393, 511-512). None of the individual respondents testified that he chose the Endowment's coverage over a cheaper policy in order to further the Endowment's educational goals. None testified that he thought the gross premiums charged by the Endowment exceeded the economic value of the insurance that he purchased.

Reviewing all this evidence, the Claims Court concluded that it was impossible to isolate a single national market for insurance (Pet. App. 51a-52a), and that, in view of geographical and risk factors unique to each insured, insurance was a difficult commodity to value (*id.* at 29a n.4,

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[4] This evidence points up the error of respondent's assertion (Br. 4-5 n.3) that "the 'net cost' of insurance to members of other professional associations is very low when compared to the Endowment's plan."

50a-51a & n.12).[5] In general, however, the court found that the Endowment's "gross premiums were set with reference to the rates for other insurance products available in the market" (Pet. App. 29a (footnote omitted)). It found that the "Endowment staff reviewed other insurance products available to ABE members and compared them to those offered by the Endowment. Where appropriate, adjustments were made to keep the cost of ABE insurance more or less competitive" (*ibid.*). The court found that the Endowment's "advertising [was] aggressive, and in some ways suggested that [its insurance] may be the best deal in the market, and indeed, for many people, from the best [the court could] tell, across the country it may very well have been a very good deal, and perhaps the best deal" (Br. in Opp. B13). As to the four individual respondents, the court concluded that each had failed to prove "that an equivalent insurance product was available to him for a lower price and that he by-passed that product because he wished to make a charitable contribution to the Endowment" (Pet. App. 52a (footnote omitted)). And the Federal Circuit, while disagreeing with the Claims Court's disposition of the charitable-contribution issue as a legal matter, accepted both its particular findings about the individual respondents and its

[5] Respondents make much of the Claims Court's findings in this respect. See Resp. Br. 11-12. Respondents, however, had the burden of proving that the Endowment's prices exceeded the generally-prevailing market range; to the extent that this task was complicated by the inherent difficulty of valuing insurance, their case was the weaker, not the stronger, for it. And while the Endowment's prices were surely more attractive to some ABA members than to others (see *id.* at 11), this case involves the taxability of the dividends generated by the 20% who actually bought the insurance. Members who found the Endowment's prices attractive—either because they did comparison shopping or because they read the Endowment's literature—presumably make up the bulk of the 20% enrolled (see Br. in Opp. App. B12-B13).

general finding that the Endowment "set the premium at a level competitive with other insurance on the market" (Pet. App. 4a).

These factual findings, which are really the dispositive factual findings in the case, destroy the predicate of respondents' "dual payment" contention. The Endowment's insurance operation differs from a charity dinner because the insureds who buy the insurance, unlike the diners who "eat rubber chicken" (Resp. Br. 43), get just what they pay for—insurance at fair market retail prices. Although the Endowment is fond of saying that its prices are "higher than necessary" (*id.* at 5, 25), this is only a play on words. Everyone who tries to make a profit, rather than simply cover his costs, charges prices that are "higher than necessary," but this does not mean that the price he charges exceeds the fair market value of what he sells. And although respondent is fond of noting that the New York Bar insurance plan cost less than its own plan did (Br. 11 n.7, 41), that does not mean that the Endowment charged more for its insurance than it was worth; as noted above (at 9), twenty other state bar plans cost more than the Endowment's. Contrary to respondent's theory, a tax-exempt organization need not undersell every other competitor in the marketplace in order to be engaged in a "trade or business." Especially is that so since the Endowment, unlike the New York Bar and most of the Endowment's other competitors, tells its insureds that they can reduce the after-tax cost of its insurance by claiming part of their premium payment as a tax-deductible charitable contribution.

3. Respondents make several other arguments that may be answered more concisely:

a. In our opening brief (at 3-6, 30, 33-35), we explain our view of the economics behind the Endowment's high profits. The Endowment largely avoids tackling the points we make, except in one particular. It says that what

we call its "very valuable, but virtually cost-free, asset—a pool of potential insureds, all ABA members, who have far-above-average mortality and morbidity experience" (*id.* at 33-34)—does not account for more than a tiny measure of its revenues (Resp. Br. 28). It suggests that every underwriter, broker and plan administrator in the country has access to the same pool of insureds, and need pay only $10,000, the price of obtaining the ABA's mailing list, for the privilege.

This assertion is insubstantial. An outsider cannot command the loyalty and attention of ABA members the way the Endowment does, not for $10,000, not for any price. One reason the Endowment's program succeeds is that ABA members are attached to what a witness called "the substance of the organization" (J.A. 317-318). An outsider would probably have had a hard time getting the ABA's lawyers even to open and read the solicitation letters that it mailed to them. The individual respondents confirmed that they liked the idea of "participating through [their] professional association" (*id.* at 269-270, 287). Another member was drawn to the program in part because he thought that the ABA "would certainly have the clout to deal with the insurance company" (*id.* at 453). The group policyholder in *Professional Insurance Agents* v. *Commissioner, supra,* was likewise "in a superior position to exploit its own membership list, not only because of its direct access to the members but also because of its position as a trusted and responsible representative of their interests" (78 T.C. 246, 264 (1982)). The Tax Court found there that the association's endorsement was "a uniquely valuable commodity from the standpoint of an insurance company" (*ibid.*), and the same is true of the Endowment's endorsement here.

b. Respondent likewise makes little effort to blunt the force of the legislative history on which we rely (see U.S. Br. 19-22). From that legislative history, which deals

with the insurance activities of fraternal beneficiary societies, voluntary employees' beneficiary associations, and veterans' groups, it is clear that Congress regarded an exempt organization's operation of an insurance program as a "trade or business," even though the business is conducted mainly with members of the organization. Respondent offers no analysis of this legislative history; it simply asserts that it has "no relevance to the factual setting of this case" (Resp. Br. 31). And the only ground respondent tenders for labeling this legislative history irrelevant is the assertion that "the legislative history has never before been advanced [by the government] in the long administrative and judicial history of the case" (*id.* at 30).

Respondent's argument is meritless. In the first place, we did rely on this legislative history in the court below (C.A. Br. 39 & n.28 (citing S. Rep. 91-552, *supra*, at 68)). Even if we had not previously relied upon it, we would be free—indeed, we would be obliged—to bring pertinent legislative history to this Court's attention now. And this legislative history is quite pertinent indeed. The tax-exempt groups that Congress discussed had available to them the very same argument that the Endowment [illegible]ses here—that they sold insurance exclusively [illegible]eir members and thus "depend[ed] on the consent [illegible]heir] customers for [their] profits" (Pet. App. 41a). In describing the insurance activities of those membership groups as a "business[]," Congress indicated that the notion of a "group gift" has no place in the legal analysis required by Section 513(c). See H.R. Rep. 91-413, *supra*, at 47; S. Rep. 91-552, *supra*, at 68.

c. On the charitable contribution issue, the individual respondents seem to accept, almost verbatim, our statement of the controlling legal standard. Compare U.S. Br. 40-43 with Resp. Br. 39-40. Their sole contention is that they bore their burden of proving that the price they

paid for the insurance far exceeded the fair market retail value of the coverage they purchased. See Resp. Br. 41-43. As we showed in our opening brief (U.S. Br. 43-47), and as we have reiterated above (at 8-11), this is precisely what the Claims Court correctly held that respondents had failed to prove.

d. The Endowment properly emphasizes its significant and longstanding accomplishments in the field of legal education (Resp. Br. 6-7 & n.4, 37). We applaud these efforts. The fact that a charity does good, however, is not inconsistent with the requirement—a requirement that Congress imposed in 1950—that it pay income tax when it finances its good works by operating an unrelated "trade or business." We think that the Endowment's insurance activities amount to a "trade or business" under the statutory standards that Congress has enacted.

CONCLUSION

For these reasons and those set forth in our opening brief, the judgment of the court of appeals should be reversed, and the cases should be remanded to that court with instructions to reverse the Claims Court's judgment in the Endowment's case and to affirm the Claims Court's judgment in the cases of the individual respondents.

Respectfully submitted.

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